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Portfolio strategies of fund managers in the Indian capital market

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Abstract This paper examines whether Indian fund managers follow an active portfolio strategy. Interalia, the impact of asset size and market capitalisation on fund performance and the fund managers' ability to create value to the fund they manage is also addressed. The study finds that fund managers exhibit poor stock-selection skills and do not seem to exhibit any distinguishable ability in timing. It signals that they are unsuccessful in determining the right time to enter/exit the market.
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Introduction

The Indian capital market has been witnessing sweeping changes in the investment environment in the past two decades. The environment has been marked by increased competition and integration of global financial markets. In this changing financial landscape, a number of investment opportunities is available for investors to channelise their savings. One such preferred investment option is mutual funds. It provides a means of participation in the stock market for people who on their own cannot successfully construct and manage an investment portfolio. Primarily, investors invest in mutual funds either for risk reduction through diversification or ability of manager to pick the right stock, or both. Retail investors' savings are most often deposited in mutual funds; the theory behind that is that pooling together a large aggregation of individual savings and investing them based on the professional judgement of the fund manager takes advantage of volume buying, scientific data analysis, expertise, and so on. Therefore, it is seen as the ideal option for an individual who does not have the time, knowledge or experience to make a succession of judgements involving his/her savings. The ability of mutual funds to provide impressive returns consistently over longer periods of time is a true indicator of their worthiness.

Mutual funds are the most significant vehicle of collective investing and provide investors with professional asset management and opportunities for diversification (Rompotis, 2008). The contribution of mutual funds to the growth of capital markets measured on the basis of mutual fund assets as a percentage of market capitalisation is 10% for India as compared to 28% for UK, 81% for Brazil, 75% for France, 104% for USA, and 123% for Australia. However, the Indian mutual fund industry is growing at a much higher rate as compared to other major countries. The Compounded Annual Growth Rate (CAGR) over a period of 10

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years for the mutual fund industry in India is 22% as compared to USA (5.7%), UK (6.6%), France (9.8%) and Australia (11%). This shows the tremendous scope for the growth of mutual funds in India (Mitra, 2009).

With reference to the performance of fund managers, the essence of performance evaluation is to measure the value of the services, if any, provided by the portfolio management industry. It is to investigate whether a fund manager helps enlarge the investment opportunity set faced by the investing public and, if so, to what extent the manager enlarges it (Chen & Knez, 1996). The quest for active portfolio managers who can deliver abnormal excess returns and beat a specified benchmark has been critical for the portfolio management industry (Knight & Satchell, 2002).

The measurement of fund performance has been a topic of increased interest in both the academic and practitioner communities for the last four decades. It is more so because of the growing scale of the mutual fund industry and also because of its implication for efficient market theory. A periodic evaluation of fund performance helps investors know whether the fund managers add value to the portfolio managed by them or destroy value by enhancing transaction cost through active investment strategies.

The remainder of this paper is structured as follows. The next section provides a brief review of existing literature relevant to this study. The section following that presents the details of data and methodology. The empirical results are then reported in the penultimate section. The last section concludes the paper.

Review of literature

The academic literature on performance of mutual funds is extensive and the overall conclusions have been remarkably consistent, indicating that mutual fund schemes were unable to earn significantly superior risk-adjusted excess returns to appropriate market or benchmark indices. The studies also present mixed results with regard to market-timing abilities of the fund managers.

Treynor and Mazuy (1966) investigated whether mutual fund managers can outguess the market. In this context, the study examined whether there is any evidence that the volatility of the fund was higher in the years when the market did well than in the years when the market did badly. The study concluded that the best assumption for an investor would be that fund managers have no ability to outguess the market and thus they should not be held responsible for failure to foresee changes in the market climate.

Henriksson and Merton (1981) developed a statistical framework for parametric and non-parametric tests of market-timing ability of fund managers. If the manager's forecasts were observable, the parametric test could be used without further assumptions on distribution of security returns. In case they were not, the parametric test under the assumption of either Capital Asset Pricing Model (CAPM) or multi-factor return structure could also be used. These specifications permitted identification and separation of gains of market-timing skills from the gains of micro stock-selection skills.

Kon (1983) provided evidence of significant superior timing ability and performance at the individual level and posited that fund managers as a group have no special information regarding the formation of expectations on the returns of the market portfolio. Jagannathan and Korajczyk (1986) concluded that if the funds being analysed tend to hold assets that are less option-like (high-quality) than the average asset in the market proxy, then one would expect to see negative timing and positive selectivity measures. Lee and Rahman (1990) reported that at the individual fund level, there was some evidence of superior forecasting ability on the part of the fund manager.

Chen, Lee, Rahman, and Chan (1992) found little evidence of market-timing or security selection ability and found that fund size and expense ratio were related positively to selectivity and negatively to market timing. Coggin, Fabozzi, and Rahman (1993) showed that the average selectivity measure was positive and the average timing measure was negative regardless of the choice of benchmark and estimation model. They also reported that both selectivity and timing abilities of the managers appeared to be sensitive to the choice of a benchmark when the fund managers were classified by investment style. Ferson and Schadt (1996) suggested that conditioning on public information controls for biases in conventional market-timing models and makes the average performance evaluation process better. Jayadev (1996) evaluated the performance of two growth-oriented mutual funds and found that both the funds were poor in earning better returns either through market-timing strategy or by selecting underpriced securities.

Bello and Janjigian (1997) used an extended version of the Treynor—Mazuy (TM) model to examine the market-timing and stock-selection abilities of fund managers. Working on a sample of 633 US equity mutual funds, they found evidence of positive and significant market-timing abilities which is in sharp contrast to the results of the original TM model. They also found that the cross-sectional correlations between market timing and selectivity are significantly negative. Gupta and Sehgal (1998) studied market-timing abilities of mutual fund managers and found that only 3 schemes out of 73 exhibited market-timing abilities.

Bollen and Busse (2001) examined the ability of mutual fund managers to time the market and reported that timing results cannot be explained simply as a spurious statistical phenomenon. Gallagar (2001) indicated that Australian pooled superannuation funds did not exhibit significantly positive security selection or market-timing skill.

Benson and Robert (2004) found that funds were unable to time the market and showed an inverse relationship between market-timing and selectivity performance. Roy and Deb (2004) examined conditional performance evaluation on a sample of 133 Indian mutual fund schemes. They measured the performance in the conditional framework advocated by Ferson and Schadt, and Christopherson, Ferson, and Glassman. The effect of incorporating lagged information variables such as interest rates, dividend yields, term structure yield spread, and a dummy for April effect on fund performance was examined in the Indian context. The results suggested the use of the conditional framework for Indian mutual fund managers. Besides, it concluded that the historical economic information is the basis for future fund performance.

Drew, Madhu, and Wilson (2005) found that there is no evidence of substantive inverse relationship between

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